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The Great Alpha Merry-Go-Round

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Portable alpha fascinates me, but it's a paradox. Portable alpha is all the rage in institutional investing today—and for good reason. Yet portable alpha is derived from the capital asset pricing model, and the CAPM has failed more empirical tests than any other element of the body of idea we usually call modern portfolio theory. Indeed, in 2004, Eugene Fama and Kenneth French put the situation this way:

> The CAPM, like Markowitz's portfolio model on which it is built, is . . . a theoretical tour de force. We continue to teach the CAPM as an introduction to the fundamentals of portfolio theory and asset pricing . . . but we also warn students that, despite its seductive simplicity, the CAPM's empirical problems probably invalidate its use in applications.[1]

All the same, in recent times, the CAPM has provoked radical changes in the way institutional investors allocate assets, select managers, decide their priorities, and determine the split between active and passive management. So suddenly the mass of empirical problems has faded into the background, and the CAPM rules the waves.

The central contribution of the CAPM to portfolio theory has been to create an awareness of the difference between what Sharpe termed "systematic risk," or the risk of investing in an asset class, and "unsystematic risk," or the risk of owning any individual component of the asset class. And a central tenet of the CAPM is that you can expect a return only from an asset class as a whole, because you can diversify away the risk in any individual component. As a consequence, the whole focus of tests of the CAPM has been on how well the beta factor predicts the return on an investment, and the residual of the model, or alpha, is just that—a residual.

Therein lay a fact of great simplicity that no one noticed for a long time. The returns from beta and alpha (positive or negative) are uncorrelated with each other. Under these conditions, why should investors look for active managers who would both provide the asset class return and seek a premium return in the form of alpha? Why not split the tasks by indexing the asset class and paying active managers only for producing an alpha? Thanks to the miracles derivatives can create, the mechanics of all this became a simple matter. Now you have the opportunity to have your policy portfolio and aim to outperform it too.

As Edward Schwarz, Joanne Hill, and Thomas Schneeweis have explained it in an essay on the usefulness of financial futures,

> Futures allow long-term investors to separate the broad asset allocation decision (stocks versus bonds versus cash) from the choice among assets in each of these categories. This separation [of investment tasks] facilitates specialization in investment management and thereby encourages the development of new money management products . . . . The opportunity to capitalize on specialized investment management skills has yet to be utilized in the long-term money management business.[2]

This was published in 1986! Although a few courageous pioneers were into applications of portable alpha before the wave of interest in the last couple of years, the interesting question is why so many investors took so long to wake up to this opportunity.

My answer is that low expected returns on conventional asset classes in the wake of the high-tech bubble are driving investors to seek incremental returns wherever they may be found. If the bubble and bust had never come about, it's my guess that investing today would look much as it did fifteen years ago. Innovation does not happen without an external push.

I am grateful to Laurence Siegel for his insights into the subject.

[1] "The Capital Asset Pricing Model: Theory and Evidence." *Journal of Economic Perspectives*, Summer 2004.

[2] *Financial Futures: Fundamentals, Strategies, and Applications*. Homewood, IL: Irwin, 1986.